

No. 13523

United States Court of Appeals
for the Ninth District

ESTATE OF WALLACE CASWELL, Deceased;
JENNIE J. CASWELL, Administratrix,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

and

ESTATE OF CHARLES HENRY CASWELL,
Deceased; EARL W. CASWELL, Adminis-
trator,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

FILED

Brief for Petitioners

FEB 13 1953

On Petition to Review Decisions
of the Tax Court of the United States

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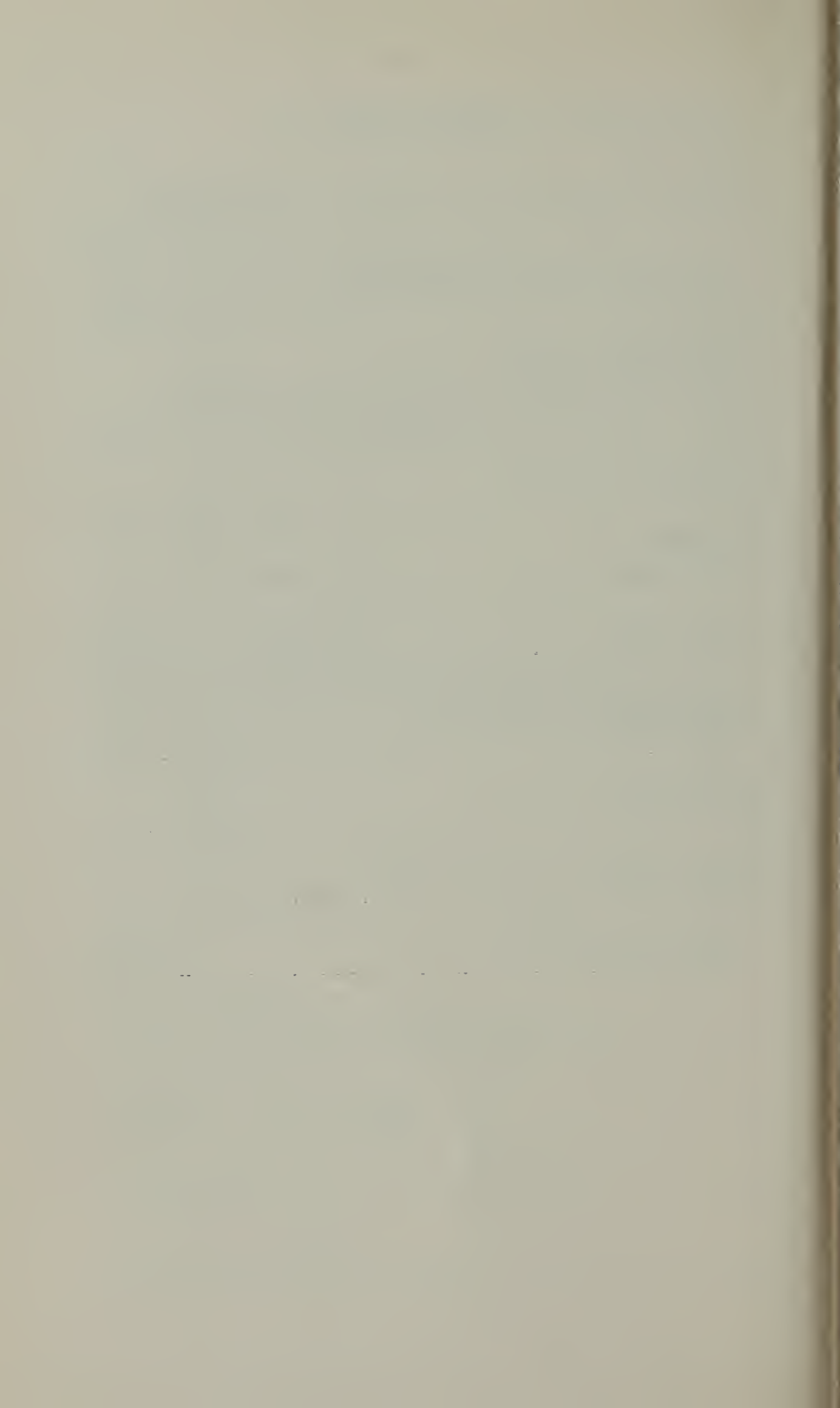
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Wareham C. Seaman
Attorney for the Petitioners

STATEMENT OF THE CASE

These are petitions to review determinations of the Tax Court of the United States (R. 40, 41) that there are deficiencies in the income tax of the petitioners for the year 1945 in the amount of \$7,828.97 for the Estate of Wallace Caswell and in the amount of \$5,278.10 for the Estate of Charles Henry Caswell, under the provisions of section 1141, 1142, and 1143 of the Internal Revenue Code (Pt. 1, 53 U. S. Stat. at L.; Title 26, United States Code), as amended by section 36, Act of June 25, 1948 (62 U. S. Stat. at L. 991; Suppl. II, United States Code, 1946 Ed, p. 684). The opinion of the Tax Court (R. 20) is reported at 17 TC 1190.

The asserted deficiencies are based upon the inclusion, by the respondent in the income of the petitioners, of amounts represented by the issuance of Certificates of Indebtedness of a cooperative in the year 1945, at their face value. The petitioners, being on a cash basis, had heretofore included the amounts represented by the Certificates of Indebtedness as income in the year of payment or redemption, rather than in the year of issue as insisted upon by the respondent.

As a second and additional issue in this case, petitioners claim that should it be found that the amounts represented by the Certificates of Indebtedness are taxable in the year of issue, the amounts are taxable to the extent of the fair market value of the certificates, and that they have no fair market value.

The Respondent found such certificates to have a fair market value equal to their face value.

The findings of the respondent were confirmed by the Tax Court in its finding of fact (R. 20), and the validity of that finding on the basis of the stipulation of facts (R. 42-60) is the issue in these petitions for review.

FACTS INVOLVED

All the facts in this case were stipulated (R. 42-60) and in summary these facts are as follows:

Petitioners were individuals engaged in the farming business, reporting their income on the cash receipts and disbursement basis. Petitioners were brothers and marketed their peach crop as partners through the Turlock Cooperative Growers Association, a farmer's marketing association (Exhibit 2, first paragraph) located at Modesto, California, of which they were members, pursuant to a crop contract (Exhibit 4, R. 55) which is executed between the Cooperative and the Grower, whether a member or not (R. 47). Title to the crop passes to the Cooperative before harvesting (Exhibit 4, reverse). Peaches from all growers were placed in a pool and as sold the proceeds were paid to the grower, less an amount withheld by the Cooperative which is ultimately represented by the issuance of Certificates of Indebtedness, usually in the following year. (R. 45 and Exhibit 1, R. 50-51). These certificates for the year involved call for interest of six percent (6%) per annum payable upon redemption of the certificate

(Exhibit 1, R. 50). The certificates are redeemable at the sole discretion of the Board of Directors of the Cooperative (R. 47 and Exhibit 2, Art. XIII). The Certificates at issue, issued in 1945 on the 1944 crop (R. 44), had not, at the time of stipulation, November 13, 1950 (R. 60) been redeemed (R. 44). Nor had those certificates issued after June 1, 1943 been redeemed, and there had been no redemptions since 1948 (R. 48), although prior to that time, redemptions were made within four or five years after issue (R. 48). The certificates were not negotiable but were assignable by the growers (R. 46). The certificates were not secured, were inferior to the other obligations of the Cooperative (Exhibit 2, Article XIII, section 4,) and inferior even to the membership fund (R. 45). Six certificates were assigned in 1944 and thirteen in 1945, but the records of the Cooperative do not indicate the circumstances surrounding the transfer such as settlement of Estate, marital settlements, credit settlements, etc., nor the amount received by the grower for a transfer if on a sale (R. 46).

STATUTES AND REGULATIONS INVOLVED

The parts of the income tax law (sections 22(a) and 42(a), Internal Revenue Code, Title 26, United States Code), and the regulations promulgated thereunder, (Regulations 111; sections 29.22(a)-7 and 29.42-2) which are chiefly involved in this proceeding are copied hereunder for the convenience of the Court.

INTERNAL REVENUE CODE:

SEC. 22(a) GROSS INCOME: GENERAL DEFINITION

“Gross income” includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever

SEC. 42(a) PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED

General Rule—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period

REGULATIONS: 111:

SEC. 29.22(a)-7 GROSS INCOME OF FARMERS

A farmer reporting on the basis of receipts and disbursements (in which no inventory to determine

profits is used) shall include in his gross income for the taxable year (1) the amount of cash or the value of merchandise or other property received during the taxable year from the sale of live stock and produce which were raised during the taxable year or prior years, (2) the profits from the sale of any live stock or other items which were purchased, and (3) gross income from all other surces

SEC. 29.42-2 INCOME NOT REDUCED TO POSSESSION

Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. A book entry, if made should indicate an absolute transfer from one account to another. If a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute a receipt.

POINTS ON WHICH
THE PETITIONERS RELY

I. The findings in the opinion below were inconsistent with the stipulation of facts, which were the only facts of record.

II. The opinion below was contrary to the Internal Revenue Code and the Regulations promulgated thereunder, and was erroneously based on an inapplicable section of the Internal Revenue Code.

ARGUMENT

I. The findings in the opinion below were inconsistent with the stipulation of facts, which were the only facts of record.

Throughout the Tax Court's opinion, the Tax Court treats the relationship of the holders of Certificates of Indebtedness of the Cooperative as that of a member, contrary to Stipulation Paragraph 12 and Exhibit 4. Neither on the face nor reverse of Exhibit 4, the contract between the grower and the Cooperative, is mention made that the contract is between a member and the Cooperative, except as the contract serves as an application for membership pursuant to Paragraph 19 thereof. The contracts also were made with non-members (R. 47).

At (R. 25), the Tax Court states, "All other rights, interests, and participations were to be according to the patronage or participation of the member in the crop marketing program", implying participation in the conduct or management of the Cooperative, according to the proportions of Certificates of Indebtedness held by a grower. The only right of the

holder of a Certificate of Indebtedness is to redemption of the certificate if, as and when, in the sole discretion of the Board of Directors of the Cooperative, such redemption is advisable, with payment of interest accumulated at that time, and with the right to assign such Certificates. A non-member may hold such certificates, or a member may withdraw his membership without affecting his holding of a Certificate of Indebtedness.

The Tax Court (R. 37) states that the Certificates were, "nonetheless securities evidencing valuable rights or interest in the commercial reserve which belonged to the Caswells and which without restriction, other than that the transfers thereof be recorded on Turlock's books, could be sold, traded in, or assigned", well knowing the limitations of assignment by law, and ignoring the express provision of Section 4, Article XIII, of the By-Laws, as shown in Exhibit 2.

The Tax Court further (R. 38) indicates that such assignments were "usual and customary", for valuation purposes, because six certificates were transferred in 1944, and thirteen in the year 1945, contrary to Stipulation 10 (R. 46) that the records of the Cooperative do not show whether the transfers were voluntary sales, or estate or marital settlements, etc.

The Tax Court (R. 38) implies the payment of interest separately from principal, as would be expected for dividends on preferred stock. This is contrary to Exhibit 1, (R. 50) and Exhibit 2, Article XIII, Section 5.

The Tax Court further states (R. 38) that, "the record also indicates the practice on the part of Turlock of retiring or redeeming outstanding certificates at face before too many years had elapsed." The stipulated facts (R. 47) indicate that in 1941, part of the redemption of that year was for certificates issued four years previously, whereas up to November 13, 1950, there had been no redemption of the certificates issued after June 1, 1943, and no redemptions since 1948.

At (R. 39), it is held that the certificates had a value equal to their face value, which ignores the statement in the preceding paragraph of the opinion that the stipulation included the opinion of two local bankers that the certificates were not even marketable.

The Court found that the Cooperative balance sheet "gives every indication that the value back of the Certificates covered them at face", (R. 39), whereas the balance sheet, Exhibit 3, shows current liabilities of \$337,634.64, plus \$274,402.72, currently due growers from the current crop after allowance for Withhold, or a total of \$612,037.36 compared to current assets of \$766,707.84 of which almost half, or \$364,681.28 is in inventory which at best is subject to fast and wide fluctuations in value.

The Tax Court states (R. 39) that "Turlock was well-known in the community as being in sound condition and well-managed". By this statement the Tax Court accepts the opinion of Mr. Puccinelli, Exhibit 5, but in the previous paragraph of its decision

ignores the opinion of Mr. Puccinelli that the certificates were not marketable. Moreover, Mr. Puccinelli's opinion was stipulated to the effect that the cooperative "enjoys a magnificent reputation in the canning industry", which statement would have to be greatly enlarged to include the community or public at large, the means of establishing the market for the certificates.

II. The opinion below was contrary to the Internal Revenue Code and the Regulations promulgated thereunder, and was erroneously based on an inapplicable section of the Internal Revenue Code.

The Tax Court based its decision upon section 111 (b) of the Internal Revenue Code (R. 38). It is the contention of the petitioners that such section is for the purpose of determining gains or losses from the sale of capital assets, apparently recognized by this Court in its decision in *Westover vs. Smith*, 173 F(2) 90. Regulations 111, section 29.111-1, dealing with computation of gain or loss begins, "except as otherwise provided, the Internal Revenue Code regards as income or loss sustained " and the only examples cited therein indicate gains or losses from the sale of capital assets and not profits or amounts realized from disposition of crops, inventories, or stock-in-trade. It is petitioners' contention that such profits or realized income are "otherwise provided" for by sections 22(a) and 42(a) of the Internal Revenue Code, the pertinent parts of which

are reproduced herein for the convenience of the Court.

The Tax Court further implies (R. 36), but later denies (R. 37), that its decision is supported on the basis of constructive receipt by its decisions in the *San Joaquin Valley Poultry Producers Association vs. Commissioner*, 136 Fed (2d) 382, *Colony Farms Cooperative Dairy, Inc.*, 17 TC 688, *George Bradshaw*, 14 TC 162, and *Harbor Plywood Corporation*, 14 TC 158. The *Poultry Producers* case, *supra*, concerned section 101 (12), Internal Revenue Code, determining the exemption of a cooperative and not the taxability of income to a grower. The *Colony Farms* case, *supra*, dealt with fixed and legal obligations of a cooperative and again was concerned with section 101 (12) of the Internal Revenue Code, determining the tax exempt status of the cooperative taxpayer. The *Bradshaw* and *Harbor Plywood* cases, *supra*, are distinguishable on the ground that there the taxpayers were on the accrual basis of accounting rather than on the cash basis.

The Tax Court (R. 37) discusses the conduit doctrine as applied in the *Bradshaw* case just cited. It is your petitioners' contention that had Congress intended to treat cooperatives as partnerships, which is the inevitable result of the Commissioner's determination and the Tax Court's theory therein, this status could have been completely established by reference to sections 181-190 of the Internal Revenue Code which, as Supplement F, deals with partnerships.

The Tax Court throughout its opinion indicates that the amounts represented by the Certificates of Indebtedness were, in fact capital contributions. It is respectfully submitted that working capital can be secured as readily by indebtedness as by capital contribution. See *John Kelley Company v. Comny*, 326 US 521, and *Talbot Mills v. Comm.*, 326 US 521. Petitioners further contend that the issuance of the Certificates of Indebtedness at least one year after title had passed to the Cooperative and pursuant to the agreement with the grower, accomplished nothing more than evidence the indebtedness of the Cooperative to the grower and was not a discharge of the indebtedness. Moreover, if the aliquot portion of the crop represented by the Certificates of Indebtedness is to be considered as a capital contribution, then your petitioners submit that there should be no recognizable gain or loss from such contribution as provided in section 112 (b) (5) of the Internal Revenue Code.

The effect of the treatment of the Tax Court of the Certificates of Indebtedness in the hands of your petitioners is to completely destroy the relief intended by Congress in section 101 (12), Internal Revenue Code, which legislatively was a relief provision for the benefit of cooperatives, and is to nullify its relief by shifting the burden of immediate tax from the cooperative to its members. There is nothing in the legislative history of that section to indicate that

Congress intended to draw a distinction between the treatment of members on the cash or accrual methods or between the treatment of disbursements of proceeds whether current or deferred. That section is completely silent on its application to the members, and the fiction of conduit, agency, or partnership status is administrative legislation.

Your petitioners contend that they are properly taxable under sections 22(a) and 42(a) of the Internal Revenue Code. Further, that there is no constructive receipt because not reduced to possession as required in section 29.42-2 Regulations 111, nor in section 29.42-3, Regulations 111 which states, "An amount credited to shareholders of a Building and Loan Association, when such credit passes without restriction to the shareholder, has a taxable status as income for the year of the credit. If the amount of such accumulation does not become available to the shareholder until the maturity of a share, the amount of any share in excess of the aggregate amount paid in by the shareholder is income for the year of the maturity of the share." J. D. Amend, 13 TC 178 (Acquiesced in by the Commissioner); *Farmers Cooperative Company v. Birmingham*, 86 Fed. (2d) 201; and *Samuel K. Jacobs*, 22 BTA 116. Petitioners further contend that the issuance of the Certificates of Indebtedness were not the equivalent of cash because they were evidence of a presently existing debt. In *Schlemmer v. U. S.*, 94 F (2d) 77, Judge Lerner said "The only actual testimony was that the note was not taken as payment of the

debt, but only as more permanent evidence of the debt. Indeed, it is not at all clear that it would have been a cash item, even if it had in fact been taken as payment. It did not change the substance of the debt—not being endorsed or secured—and although it was more readily disposable, that single incident was scarcely enough. There must be more than difference in the mere form of property to justify a charge of income.” This case was cited to support 1T 3342, 1940-1 CB 58, wherein the Commissioner held that “the holders of notes will not be required to include the amounts thereof as income until such payments are received.” In *Joplin*, 17 TC 1526, just after its decision in the instant case, the Tax Court found that cash basis taxpayers were taxable on issuance of authorized preferred stock, \$25 par value, but not on amounts credited to the capital reserve account of the cooperative simply because there was no evidence issued of such credit, although the right to retain was similar to the cooperative here involved.

The petitioners here contend that the Certificate of Indebtedness does not fall within the definition of “other property” found in sub-paragraph 1 of the first paragraph of section 29.22(a)-7 because it is nothing more than an evidence of indebtedness, insecure at best; in fact, less secure than an open account which relies on the general credit of the cooperative.

The absence of a maturity date precludes any equivalence of cash. See *Bedell v. Commissioner*, 30 Fed

(2d) 622 where the Court said "it is absurd to speak of a promise to pay a sum in the future as having a 'market value', fair or unfair". In the case of *Burnett v. Logan*, 283 US 404, it was held that where the receipt of future payments is contingent and uncertain, no income may be realized in the year in which the sale or other disposition of the property takes place. *Edward J. Hudson*, 11 TC 1042, acquiesced in by the Commissioner, held that non-negotiable notes which were not unqualifiably payable in money or at a certain time were not equivalent of cash and not income to the taxpayer who was on a cash basis in the year that they were issued.

The immediately preceding statements also support petitioners' contention that the Certificates of Indebtedness were without market value. To further this contention, petitioners respectfully submit that the Certificates were non-negotiable, were assignable only, were inferior to all claims against the Cooperative, conferred no rights of management nor participated nor benefitted from able management except as it might assure payment if, as and when that management deemed redemption desirable.

CONCLUSION

The Tax Court, in the present decision, indicates by its improper reliance on section 111(b) that it still cannot justify its action under the Internal Revenue Code, having previously tried the theories of constructive receipt, of equivalent of cash, and of a conduit, agency, or partnership. The Internal Revenue Code, and the Regulations promulgated thereunder, in sections 22(a) and 42(a) clearly set forth the rules for taxation, as contrasted with section 111 (b), relied on by the Tax Court, which deals with capital transactions.

Briefly stated, here we have:

1. A cash-basis taxpayer
 - a. Selling his produce to a buyer, a Cooperative,
 - b. Of which he may or may not be a member,
 - c. By an arms-length contract setting forth the terms of payment, partly by cash,
 - d. Partly by a general obligation of the buyer
2. Which later is evidenced by a Certificate of Indebtedness,
 - a. Certain as to amount,
 - b. And, unlike capital stock, transferable only by assignment and not by negotiation,
4. With the balance sheet of the buyer indicating that the security of the certificates rests upon the full realization of an inventory of food products (highly speculative) constituting one-fourth of the

assets at the time of the issue as contrasted with almost three-fourths of the assets five years after issue.

5. The acceptance of these contingencies by the petitioners was in the expectation of ultimately realizing more from the sale of their products

6. With tax liability properly established upon such realization.

